No. 10088.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CONSOLIDATED ROYALTIES, INC., a corporation, and C. B. CALLAHAN,

Appellants,

vs.

HARRY ASHTON, Trustee of the Estate of DEEP HOLE DRILLING CORPORATION, a corporation, Bankrupt, *et al.,*

Appellees.

BRIEF OF APPELLANTS.

FLEMING & ROBBINS and
C. S. TINSMAN,
1121 Los Angeles Stock Exchange Building, Los Angeles,
Attorneys for Appellants.

Parker & Baird Company, Law Printers, Los Angeles.

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Preliminary Statement.

This appeal concerns a controversy in bankruptcy. Harry Ashton, as trustee of the estate of the Deep Hole Drilling Corporation, a bankrupt, obtained an order to show cause directed to appellants, and I. Rude, Howard Supply Company, Fred Lundberg, J. C. Hayward, Standard Oil Company of California and Union Oil Company of California, which order, among other things, required appellants to show cause why their respective interests in the oil produced from Well #1 should not be delivered to the trustee for benefit of creditors. This appeal concerns only the order made respecting the interest of appellants in and to the proceeds of producing

Well #1, which was operated by the bankrupt, as lessee, and appellee, both as receiver and trustee. The other respondents in the order to show cause and above named had interests in said producing well, but those interests are not involved in this appeal, with the possible exception of the Howard Supply Company and the Standard Oil Company, purchaser of the oil. Where appellee is referred to in this brief, the same applies only to Harry Ashton, trustee in bankruptcy for the estate of the Deep Hole Drilling Corporation. The principal questions involved are the relationship of appellants to the bankrupt, did the bankruptcy court exceed its jurisdiction in subordinating appellants' royalty interest to the rights of the general creditors, and if it had jurisdiction to do so, did the court err in making the order?

Jurisdictional Statement.

Deep Hole Drilling Corporation filed a petition for an arrangement with creditors under Section 322, Chapter XI, of the Bankruptcy Act (11 U. S. C. A., 722) on September 23, 1939. Appellee, Harry L. Ashton, was appointed receiver. The corporation was adjudicated bankrupt on April 22, 1940, and appellee was appointed trustee of the estate of said bankrupt.

Appellants are the owners of an overriding royalty interest aggregating 12% of the oil produced from real property on which was located Deep Hole Drilling Corporation Well #1, which was acquired on March 29, 1939, by conveyance from the debtor corporation. The Standard Oil Company of California is the purchaser of the oil of Well #1. It paid appellants their said royalty to August 31, 1939, but has impounded the same since

the filing of the original petition. On May 17, 1940, appellee filed his petition for an order to show cause [Tr. p. 3] and appellants were directed to show cause why the proceeds so impounded to April 30, 1940, amounting to $846.08, should not be paid to him, as well as all other proceeds from the production of said well, and to show cause why it should not be decreed that appellants had no right, title or interest in and to the production of said well or the proceeds thereof, and why the rights of appellants should not be fixed and classified with respect to the rights of general creditors. [Tr. p. 7.] Appellants answered the petition [Tr. p. 9], alleging the facts by which appellants acquired title and reserving the objection theretofore made and overruled by the referee that the referee was without jurisdiction to summarily deprive appellants of their property.

A memorandum for an order was made by Referee McNabb on June 26, 1940. [Tr. p. 54.] However, the referee died prior to signing the order and it was stipulated between appellants and appellee that Referee Hubert F. Laugharn might sign the order. [Tr. p. 56.] The order, among other things, subordinated the 12% royalty interest of appellants in oil of Well #1 and in and to the proceeds of oil in the hands of Standard Oil Company of California to the claims of creditors arising in the drilling of Well #1, and directed the Standard Oil Company of California to pay over to the trustee all proceeds from said 12% until further order of a court of competent jurisdiction, and restrained appellants from prosecuting any action with respect to said proceeds without leave of court. Said order was signed by the referee on November 26, 1941. [Tr. p. 58.]

Within the time provided by law and on December 2, 1941, appellants served and filed their petition for review of the referee's order [Tr. p. 65] and said petition was heard, pursuant to notice of hearing on said petition for review [Tr. p. 70], on January 26, 1942, and the order of the District Court Judge thereon, from which this appeal is taken, was made and entered on January 26, 1942. [Tr. p. 72.]

Notice of appeal was duly served and filed herein on February 25, 1942 [Tr. p. 73] and an order approving the bond for costs on appeal was made by the District Court Judge on said 25th day of February, 1942.

Exclusive jurisdiction of proceedings in bankruptcy is vested in the Federal Courts.

Section 2(a), *Bankruptcy Act.*

The District Courts have original jurisdiction of all matters and proceedings in bankruptcy.

Section 41(19) Title 28, *U. S. C. A.*

The original petition herein was filed by the debtor under section 322 of the Bankruptcy Act (11 U. S. C. A. 722). Section 312(2) of the Bankruptcy Act (11 U. S. C. A. 712(2)) provides that the jurisdiction of the court shall be the same as though voluntary petition for adjudication had been filed and a decree had been entered at the time the petition under Chapter XI was filed. The debtor was adjudicated a bankrupt under the provisions of section 376(2) of the Bankruptcy Act and the pro-

ceedings were thereafter carried on pursuant to section 378(2) of the Bankruptcy Act (11 U. S. C. A. 788(2)). The provisions of Chapter I to VII of the Bankruptcy Act apply to proceedings under Chapter XI, where not inconsistent (Section 302, Bankruptcy Act (11 U. S. C. A. 702)).

This proceeding is a controversy arising in bankruptcy proceedings, being a separable issue between the appellants and the appellee concerning the right of the bankruptcy court to assume jurisdiction over appellants' property and concerns the right and title of the bankrupt's estate in and to appellants' overriding royalty interest.

Statutes under which the Circuit Court of Appeals is given appellate jurisdiction over this matter are as follows:

Section 316 of the Bankruptcy Act (11 U. S. C. A. 716) provides that where not inconsistent with the provisions of Chapter XI, the jurisdiction of the appellate courts shall be the same as in a bankruptcy proceeding.

Section 225, subdivisions (a) and (c), Title 28, U. S. C. A., grants to the Circuit Court of Appeals appellate jurisdiction of the District Court interlocutory orders and over all controversies in the District Court relating to bankruptcy.

Section 24(a) of the Bankruptcy Act invests the Circuit Court of Appeals with appellate jurisdiction over controversies arising in bankruptcy without an order of allowance when the matter involves in excess of $500.00.

Statement of the Case.

Deep Hole Drilling Corporation acquired a leasehold estate on a parcel of land in Los Angeles County, the term of which was for a specified number of years and for so long as oil and gas should be produced in paying quantities. [Tr. p. 27.] It drilled and placed on production its Well #1 on February 5, 1939. On March 9, 1939, it applied for a permit to the California Corporation Commissioner to convey to appellants a royalty interest aggregating 12% of the oil produced from the land on which Well #1 was located. [Tr. p. 27.] On March 27, 1939, pursuant to the permit obtained, it conveyed to appellants such overriding royalty interest, which was stated as not being subject to operating costs of the well or lease. [Tr. p. 28.] The conveyance was recorded on March 30, 1939, in the recorder's office. The Deep Hole Drilling Corporation was solvent at that time. [Tr. p. 45.] Unpaid claims for the drilling of Well #1 amounted to approximately $4,000.00, exclusive of the claim of Howard Supply Co., which agreed in writing not to interfere with the royalty interest of appellants. The Standard Oil Company of California was purchasing the oil from the well and has continued to do so. The debtor corporation also executed and delivered to appellants a division order directing the said oil purchaser to pay 12% of the proceeds from the oil directly to appellants, which order was stated to be irrevocable. This was accepted by the Standard Oil Company of California and royalties were paid to appellants through August, 1939. [Tr. pp. 29-

30.] The Deep Hole Drilling Corporation commenced drilling its Well #2. This well was located on property other than that covered by appellants' royalty interest [Tr. pp. 35, 47] and pursuant to the terms of another lease. The creditors of said corporation extended credit to the debtor corporation to enable it to drill its Well #2 and subsequent to the time the appellants acquired their said royalty interest. [Tr. p. 11.] Although, pursuant to the permit of the Commissioner of Corporations, the debtor corporation gave appellants an option to acquire royalty interests in other wells, these options were never exercised. Well #2 was never placed on production and the debtor corporation filed its petition for an arrangement with creditors on September 23, 1939. Harry L. Ashton was appointed receiver. The Standard Oil Company impounded the proceeds from appellants' 12% of the oil from September 1, 1939, on. The debtor corporation was adjudged bankrupt on April 22, 1940. Appellee was appointed trustee for the bankrupt's estate. On May 15, 1940, appellants filed an action in the Municipal Court of the City of Los Angeles against the Standard Oil Company to recover their unpaid royalty amounting to $846.08. [Findings, Tr. pp. 59-62.]

On May 17, 1940, appellee filed a petition for an order requiring appellants to show cause why the Standard Oil Company should not be directed to turn over to him the proceeds from appellants' 12% of the oil then on hand and to be produced thereafter and why it should not be decreed that appellants had no right, title or interest in the

production and why appellants' rights should not be fixed and classified with respect to rights of general creditors and why they should not be restrained from instituting any action except in the bankruptcy court with respect to such proceeds. [Tr. p. 3.] The order to show cause was issued. [Tr. p. 7.] Appellants answered the petition and order to show cause reserving their objection to the jurisdiction of the referee to summarily deprive them of their property. [Tr. p. 9.] Appellants, still reserving their objection to referee's jurisdiction, and appellee entered into a written stipulation covering all material facts believed necessary for the consideration of the matter by the referee, including those hereinabove set forth. [Tr. pp. 25-54.] On June 26, 1940, the referee made his memorandum for an order and directed appellee to prepare the same. [Tr. p. 54.] Referee McNabb was taken ill and passed away before the order could be presented to him. It was thereafter stipulated between the appellants and appellee that Referee Hubert F. Laugharn might sign the order. [Tr. p. 56.] The order was so signed on November 26, 1941, and found the facts to be as stipulated, including the fact that appellants did not at any time participate in the conduct, management or business of the bankrupt corporation and that it had not been shown that any creditor relied upon appellants' personal credit in furnishing labor or materials; that the 12% of the oil produced from Well #1 had been conveyed to appellants after the well was on production, when the bankrupt was solvent, and more than five months prior to filing of its

petition for an arrangement with creditors. [Tr. pp. 59-62.] As conclusion of law the referee concluded that appellants' rights and interests in the oil and in and to the net proceeds from gas produced and sold from Well #1 were subject and subordinate to the rights and interest of the trustee to the extent of $4,000.00 unpaid indebtedness incurred in drilling Well #1 and all proceeds from appellants' 12% of the oil were the property of trustee free of any claim of appellants [Tr. p. 63] and the order provided that said 12% of the oil and of the proceeds therefrom in the hands of the Standard Oil Company in the amount of $846.08, to April 30, 1940, and the proceeds after April 30, 1940, was subject to unpaid creditors' claims arising in the drilling of Well #1, to the extent of $4,000.00. Said order further directed the Standard Oil Company to pay such proceeds to the trustee and restrained appellants from prosecuting any action with respect to such proceeds unless leave of the court be first obtained. [Tr. pp. 63-64.] Upon the hearing on petition for review, the District Court Judge modified the order to the extent of decreeing that appellants were entitled to the proceeds of oil in the hands of the Standard Oil Company covering the period from September 1, 1939, to September 23, 1939, the date the petition was filed by the bankrupt under Chapter XI of the Bankruptcy Act, but otherwise adopted, approved and confirmed the findings of fact and conclusions of the referee and affirmed the order as modified. [Tr. pp. 72-73.] Exception to said order was taken by appellants and was noted. [Tr. p. 73.]

The questions invoked are:

(1) Did the referee in bankruptcy have jurisdiction to summarily deprive appellants of their 12% of the oil from Well #1 and proceeds thereof which were in the hands of the purchaser of the oil?

(2) Was appellants' oil and the proceeds thereof which was in the possession of the purchaser of the oil and which had accrued between the filing of the petition on September 23, 1939, and November 26, 1941, the date of the referee's order, subject to the jurisdiction of the bankruptcy court?

(3) Do creditors and the trustee in bankruptcy of the Deep Hole Drilling Corporation have any right, title or interest in and to appellants' 12% of the oil from Well #1, which was lawfully conveyed while the company was solvent and more than five months prior to the filing of the petition under Chapter XI?

(4) Has the case of *In re Lathrap*, 61 F. (2d) 37 (9th Cir.) been overruled by *Laugharn v. Bank of America*, 88 Fed. (2d) 551 (9th Cir.)? Is the *Lathrap* case to be followed in this matter where the facts are different and the rule of property upon which it was based has been declared by California courts not to be a rule of property in this state?

Specifications of Error Relied on.

Statement of points upon which appellants intend to rely upon appeal are set forth at pages 76-79 and 84 of the transcript. Each of said points is relied upon by appellants and such points are as follows:

I.

The referee did not have jurisdiction under Chapter XI of the Bankruptcy Act to deprive Consolidated Royalties, Inc. and C. B. Callahan of their property in the summary manner attempted.

II.

The court erred in making said order, in that, the findings were insufficient to justify the conclusion that appellants' interest in said oil and the proceeds thereof in the hands of the Standard Oil Company were subordinate to the claims of creditors incurred in drilling said well to the extent of $4,000.00, in that:

A. Appellants were conveyed 12% of the oil, which constitutes a conveyance of incorporeal interest in real property.

B. Appellants' ownership in said oil was acquired by conveyance executed more than four months prior to the filing of the petition under Chapter XI and after the well had been completed and on production and the findings disclose that insolvency resulted by reason of the extension of credit by said creditors to the debtor for the purpose of drilling Well #2.

C. Appellants' said interest was not subject to levy or sale under judicial process against the debtor; was not transferable by the debtor; could not be considered a part of the debtor's estate.

III.

The court erred in making said order, in that, said order is against the law, in that:

A. Said conveyance of the 12% of the oil was acquired more than four months prior to bankruptcy, after said well had been completed and on production, and was not a part of the debtor's estate.

B. The oil was purchased by Standard Oil Company at the well and by reason of the division order and said conveyance the same constituted funds in its hands for the benefit of appellants.

C. The court failed to follow the law of the State of California with respect to the property interest acquired in said oil by appellants and the law of said state which declares that appellants are not to be classified as joint adventurers with the bankrupt.

IV.

The court erred in making said order, in that, it relied upon the case of *In re Lathrap,* 61 F. (2d) 37,, which case appellants believe to have been overruled by the case of *Laugharn v. Bank of America,* 88 F. (2d) 551, and the California courts have, since the Lathrap decision, determined the interest so acquired was an interest in real property and not an interest in personal property, which appellants believe to have been the basis for the Lathrap case. Therefore, said case should no longer be followed.

Summary of Argument.

POINT I. The referee did not have jurisdiction to summarily deprive appellants of their property.

A. 12% of the oil and the proceeds thereof was and is the property of appellants.

B. The proceeds of said 12% were in possession of the Standard Oil Company for account of appellants payable to appellants in accordance with the irrevocable division order and was not in possession of the bankruptcy court or the trustee in bankruptcy.

POINTS II, III & IV. under specifications of error above are hereby referred to for a summary of the argument in connection with those points. In addition appellants contend under Point IV that the facts of the *Lathrap* case are so different from those in this matter that the decision in said case cannot be applied in any event.

ARGUMENT.

POINT I.

The Referee Did Not Have Jurisdiction to Summarily Deprive Appellants of Their Property.

A. The 12% of the oil produced from the land was appellants' property and was not subject to jurisdiction of the bankruptcy court.

1. The assignment of the 12% overriding royalty interest in the oil to be produced from the land was a conveyance of an incorporeal interest in real property, which vested in appellant's title to 12% of the oil.

In the case of *La Laguna Ranch Co. v. Dodge,* 18 A. C. 107; 114 Pac. (2d) 351, decided June 20, 1941, the Supreme Court of California was called upon to define the interest of an overriding royalty holder. The court discussed previous California cases and stated, that where "the assignee does not intend to attempt operation himself and is given no right of entry for such purpose, those rights are held by the operating lessee and the holders of royalty interests contemplate nothing more than the receipt of their share of the oil and gas production" . . . "The purpose and scope of all such royalty interests are so similar that all should be considered equally to be incorporeal interests in real property subject to the same requirements and protected by the same safeguards," and "Defendant's overriding royalty interests therefore were interests in real property."

The Supreme Court of Wyoming in the case of *Denver Joint Stock Land Bank of Denver v. Dixon,* 122 P. (2d) 842, decided on February 24, 1942, carefully considers the

California cases, including *Callahan v. Martin,* 3 Cal. (2d) 110, and the *La Laguna Ranch Co.* case referred to, as well as other California cases. In this case the court was called upon to decide whether oil royalty interests were covered by a mortgage or whether such rights were mere personal rights in oil after production and hence not covered by the mortgage. The court stated,

> "The right to a royalty interest in oil does not merely attach after the oil has been severed from the ground and has become personal property. It is not merely rent issuing out of the annual produce of the land. It goes further than that. The right, extending as it does to oil which is to come from particular land, extends to and is necessarily connected with the corpus of the land, and is, accordingly, a right which exists in the oil which still is in place, inchoate though it may be, follows it as it comes from the ground and still is attached after it has become personal property. To call it personal property is but emphasizing a particular stage of the right on its way to fulfillment. It ignores that it is a right which necessarily extends to part of the corpus of the land. If it were possible to divide the oil in the ground in such a manner that the land in which the royalty portion would be found could, together with the royalty interest, be delivered to the owner of the royalty interest intact, then clearly it would be considered as real property. That is not possible, but in theory the equivalent of that right, aside from bringing the oil to the surface, is substantially the right of the owner of a royalty interest in particular land. The fact that real property, when severed, becomes under our terminology and classification, personal property, should not obscure the real nature of the right."

This court held the royalty rights to be real and not personal property which were covered by the mortgage.

The latest case on this subject is that of *Taylor v. Odell,* 50 A. C. A. 158, decided by the District Court of California on February 25, 1942, which, after quoting from the case of *La Laguna Ranch Co., supra,* stated:

> "The moneys paid plaintiffs from the sales of the well's production was received as an incident to ownership the same as rent from any real property. The assignment of the royalty interest in the well of the Two and One Oil Company vested in plaintiffs an interest in the oil produced by that company. When the money for production was received by Two and One, it was held in trust for plaintiffs if the company had knowledge of the defendant's assignment."

See also the case of *Laugharn v. Bank of America,* 88 F. (2d) 551.

2. Said overriding royalty interest was conveyed to appellants more than four months prior to bankruptcy. It was not subject to levy or sale under judicial process, nor was it transferable by the bankrupt. Therefore it cannot be considered a part of the bankrupt's estate.

> "The trustee in bankruptcy gets the title to all property which has been transferred by the bankrupt in fraud of creditors or which, prior to the petition, he could by any means have transferred, or which might have been levied upon and sold under judicial process against him."
>
> *Moore v. Bay,* 284 U. S. 4; 52 Sup. Ct. 3; 76 L. Ed. 133.

It therefore appears that the trustee in bankruptcy did not have title to property which would not come under the above classification.

In the case of *In re Seiffert,* 18 F. (2d) 444, the court stated as follows:

> "The principal test seems to be whether the property in question, prior to the filing of the petition, could by any means have been transferred by bankrupt, or whether it might have been levied upon and sold under judicial process against him. Bankruptcy Act, Sec. 70(a). (Comp. St. sec. 9654)."

3. Property in which bankrupt has no ownership does not become a part of the bankrupt's estate, even though it is in the possession of the bankrupt.

This rule of law is set forth in the case of *Lynch v. Lentz,* 10 F. (2d) 561, where the trustee in bankruptcy sought to recover possession of property which had been in the hands of the bankrupt, but which had been taken in a claim and delivery action. The question was whether the property was an asset of the estate in bankruptcy. The court stated,

> "It must be conceded under the law that property found in the hands of the bankrupt as to which the latter possesses no ownership right of any quality whatsoever, does not become part of the bankrupt estate."

It is respectfully submitted, therefore, that appellants are the owners of 12% of oil in the real property upon which Well #1 is located and in and to the proceeds of said oil now in the hands of Standard Oil Company, and that such did not become part of the bankrupt's estate subject to distribution to creditors as such.

B. Chapter XI gives the court jurisdiction over the debtor's property only.

1. Section 311 of the Bankruptcy Act gives the court jurisdiction over the debtor's property only.

Sec. 331, *Bankruptcy Act,* 11 U. S. C. A. sec. 711.

2. Section 312(2) of the Bankruptcy Act provides that the jurisdiction, power and duties of the court, when not inconsistent with the provisions of Chapter XI, shall be the same where a petition is filed under section 322 of the Act as if a voluntary petition for adjudication had been entered.

Sec. 312, *Bankruptcy Act,* 11 U. S. C. A., sec. 712.

This section cannot broaden the jurisdictional limitations of Chapter XI, where such would be inconsistent with such chapter. That chapter deals only with the debtor and his property. Between September 23, 1939, when the petition was filed, and April 22, 1940, the date of adjudication, the purchaser of the oil had accumulated and held in its possession for appellants' account their 12% of the proceeds of the oil from Well #1, amounting to $846.08.

3. Section 332 of the Bankruptcy Act, providing that a receiver may be appointed for the property of the debtor, is not authority for appointment of a receiver for appellants' property.

Sec. 332, *Bankruptcy Act,* 11 U. S. C. A., sec. 732.

4. Section 343 of the Bankruptcy Act gives a receiver power to operate the business and manage the property of the debtor, not the property of others.

Sec. 343, *Bankruptcy Act,* 11 U. S. C. A. sec. 743.

The appellee, as receiver, between September 23, 1939, and the adjudication had no interest in or title to property of appellants in the hands of the Standard Oil Company.

C. Summary proceedings will not lie as to appellants' property, which is not in possession of the bankruptcy court.

1. The proceeds of appellants' oil were in the hands of the Standard Oil Company and under the irrevocable division order were payable to appellants. Under such circumstances a plenary suit must be brought by the trustee.

The Supreme Court of the United States, in the matter of *Bobbitt v. Dutcher,* 216 U. S. 102, 54 L. Ed. 402, sets forth this rule as follows:

> "There are two classes of cases arising under the act of 1898, and controlled by different principles. The first class is where there is a claim of adverse title to property of the bankrupt, based upon a transfer antedating the bankruptcy. The other class is where there is no claim of adverse title based on any transfer prior to the bankruptcy, but where the property is in the physical possession of a third party or of an agent of the bankrupt, or of an officer of a bankrupt corporation, who refuses to deliver it to the trustee in bankruptcy.
>
> In the former class of cases a plenary suit must be brought, either at law or in equity, by the trustee, in which the adverse claim of title can be tried and adjudicated."

In the case of *Merritt v. Long,* 93 F. (2d) 257 (9th Cir.) a farmer had filed a petition under section 75 of the Bankruptcy Act and claimed ownership to cattle in the possession of appellee, who also claimed ownership. Ob-

jection to the jurisdiction of the referee to try title to property was made and the referee ordered the property returned to the bankrupt. This court upheld the contention of the appellee on appeal, stating:

> "The procedural rights of a party claiming to be the owner of property are not abridged by the bankruptcy of his adversary, and in the absence of such party's consent the bankruptcy court has no jurisdiction to determine his rights in a summary way. Section 23(b), Bankr. Act 1897 (11 U. S. A. C. sec. 46(b)). Until the appellant petitioned for an adjudication of her claim to the cattle and obtained the order to show cause, there was no summary proceeding to which consent could be given or withheld; and at that juncture the appellee promptly objected to the jurisdiction.
>
> Appellee's claim of adverse title was based upon a transfer prior to bankruptcy, and came within the first of the two classes of cases distinguished by the Supreme Court in Babbitt v. Dutcher, 216 U. S. 102, 30 S. Ct. 372, 54 L. Ed. 402, 17 Ann. Cas. 969."

In the case of *Ramish, Inc. v. Laugharn,* 86 F. (2d) 686 (9th Cir.) the trustee obtained an order to show cause why an assignment of 9⅜% royalty in land was not invalid and why an order should not be made requiring appellee to turn over to the trustee all income, derived from such royalties. The transfer of the royalty to appellant's predecessor had occurred prior to bankruptcy. The district court confirmed an order of the referee directing the appellant to pay over such proceeds to the trustee. The Circuit Court said that the time to determine adverse

claims was as of the date of the filing of the petition and quoted with approval from *Mueller v. Nugent,* 184 U. S. 1, 15; 22 S. Ct. 269; 46 L. Ed. 405, as follows:

> "It is well settled that a court of bankruptcy is without jurisdiction to adjudicate in a summary proceeding a controversy in reference to property held adversely to the bankrupt's estate, without the consent of the adverse claimant; but resort must be had by the trustee to a plenary suit."

The court held that the trustee should seek his relief in a plenary suit.

See also *In re Greenbaum & Sons,* 6 F. S. 245, and *Marcell v. Engebretson,* 74 F. (2d) 93.

2. Where a fund has been set apart for the payment of an obligation or claim of obligations or a fund in the hands of third persons has been so designated as to require the latter to make a payment out of it to a person, the general rule is that the person for whose benefit the fund was so set apart or designated acquires a right to have it applied as directed, which right will be given a preference over the rights of other creditors in case of the debtor's insolvency.

In the matter of *In re Latex Drilling Co.,* 11 F. (2d) 373, the bankrupt was the operating lessee. The oil was delivered to and purchased by Standard Oil Company. The company had given the purchaser an order to pay a portion of the proceeds to Edwin Jones. The trustee in bankruptcy sought to obtain possession of these proceeds

and the referee ordered the Standard Oil Company to pay the same to the trustee. The court held as follows on appeal:

> "In circumstances like the present case, I think the opponent falls into the category of an adverse claimant, and the controversy becomes one arising in bankruptcy, as distinguished from those growing *out of* bankruptcy and as to which the jurisdiction of the court is determined according to general rules and particularly section 23 of the Bankruptcy Act (Comp. St. sec. 9607). If the defendant be in possession of the property or funds which he claims and it is found that he has colorable title thereto, he has the right to insist that he be sued at his domicile, in a proper court, state or federal. And I think the conditions are analogous where the funds are held by a third person who asserts no interest therein save the desire to pay them to the one lawfully entitled to receive them."

In the case of *Title Ins. etc. Co. v. Williamson,* 18 Cal. App. 324, the contract price for the construction of a building was deposited with the plaintiff corporation with instruction to pay the final installment to Williamson upon completion. Williamson made a written order upon the plaintiff to pay the same to Carpenter and Biles in payment of the material debt. Before the money was paid, an execution was levied. The trial court held that an assignment of the debt was worked by the written order. The appellate court stated,

> "It is very clear from the circumstances surrounding the transaction that had the money been paid over to the Carpenter and Biles Company, Williamson would have had no legal right to demand that the same be delivered by that company to him, or diverted

> in any way from its possession. As it was said in *McIntyre v. Hauser,* 131 Cal. 11 (63 Pac. 69): 'In order to constitute an equitable assignment of a debt, no express words to that effect are necessary. If from the entire transaction it clearly appears that the intention of the parties was to pass title to the chose in action, then an assignment will be held to have taken place.' "

The Supreme Court on petition for hearing, approved the decision and stated that the assignment of which the creditors had notice operated to perfect the transfer of title to the fund.

Again, in the case of *McKay v. Sec. First National Bank of L. A.,* 35 Cal. App. (2d) 349, the appellate court was called upon to determine the rights of assignee in a one-third interest in oil royalties given to pay a promissory note. In addition to the note, an order was made directing the depositary to pay such sum to the creditor. The court held that the note was in truth a partial assignment of a fund created by the oil royalties, and stated:

> "A partial assignment of a designated fund and a contemporaneously accepted order to the depositary for its payment, and no rights senior to those assigned having been established to any portion of the one-third interest conveyed by decedent to him, plaintiff's title to the portion assigned to him is indefeasible."

A rehearing was denied by the Supreme Court.

The rights of an assignee in and to trust funds have been held superior to those of general creditors.

Steel Cities Chemical Co. v. Virginia Carolina Chemical Co., 7 F. (2d) 280.

Also see the following cases:

Curtis v. Walpole Tire & Rubber Co., 134 C. C. A. 140; 218 F. 145;

Johnson v. Root Mfg. Co., 241 U. S. 160; 60 L. Ed. 934; 36 S. Ct. 520; 36 A. B. R. 764;

Sexton v. Kessler Co., 225 U. S. 90; 56 L. Ed. 795; 32 S. Ct. 657; 28 A. B. R. 85;

Merillat v. Hensey, 221 U. S. 333; 55 L. Ed. 995; 31 S. Ct. 575; 36 L. R. A. (N.S.) 370; Ann. Cas. 1912-D, 497;

In re Interborough Cons. Corp., C. C. A. (2d) 288 Fed. 334;; 32 A. L. R. 932; 2 A. B. R. (N.S.) 407.

In our case, in addition to the recorded conveyance of 12% interest in the oil to be produced, appellants were given an irrevocable division order for the payment of the proceeds of such 12% in the hands of the Standard Oil Company direct to the appellants. Appellants respectfully submit that such interest is not part of the bankrupt's estate, nor subject to the claims of creditors; that the proceeds of the oil in the hands of the purchaser of the oil were not in possession of the trustee in bankruptcy, but were held in trust for the benefit of appellants, and that the bankruptcy court therefore did not have jurisdiction to order the payment of such proceeds to the trustee in bankruptcy.

POINT II.

The Court Erred in Making the Order. The findings Do Not Support the Order Subordinating Appellants' Ownership in the Oil and Proceeds to Creditors of Deep Hole Drilling Corporation, but on the Contrary Establish Appellants' Ownership of an Overriding Royalty Interest of 12% of the Oil Produced From Well No. 1 and the Proceeds Thereof in the Hands of the Standard Oil Company, Free of the Claims of Creditors or Appellee.

A. The conveyance from Deep Hole Drilling Corporation to appellants were conveyances of an interest in the oil itself and constituted a conveyance of an incorporeal interest in the land. [Form of conveyances at Tr. pp. 19-23 and pp. 38-40.]

La Laguna Ranch v. Dodge, supra;

Laugharn v. Bank of America, supra;

Taylor v. Odell, supra;

Denver Joint Stock Land Bank of Denver v. Dixon, supra.

B. The conveyances were executed March 27, 1939, and recorded March 30, 1939, more than four months prior to filing the petition under Chapter XI, September 23, 1939, by the Deep Hole Drilling Corporation.

C. The debtor was at that time solvent. [Tr. p. 45.]

D. The creditors extended additional credit to Deep Hole Drilling Corporation for the drilling of Well #2, which constituted the substantial indebtedness of the bankrupt at the time the petition was filed. [Tr. p. 62, para-

graph 12.] This credit was extended with actual or constructive notice and knowledge of appellants' title to the oil being produced, from Well #1, as the conveyance had been recorded. (Sec. 1213, Civil Code of California.) Appellants' interests were incorporeal interests in real property, subject to the same requirements and protected by the same safeguards. (*La Laguna Ranch Co .v. Dodge, supra.*)

E. The facts establish that appellants were not joint adventurers or co-adventurers with the bankrupt, as found by referee. [Tr. p. 55.]

1. By the Stipulation of Facts [Tr. p. 31] it was stipulated that appellants did not at any time, nor have they ever, participated in the conduct, management or business of Deep Hole Drilling Corporation. That the trustee had not shown any creditor of the bankrupt delivered material to the bankrupt or performed labor for bankrupt upon appellants' personal credit. These facts were also found to be true by the court. [Tr. p. 62.]

Appellants were not, therefore, joint or co-adventurers or partners with the Deep Hole Drilling Corporation.

Spier v .Lang, 4 C. (2d) 711, 715;

Theriot v. Plane, C. C. A. (9th Cir.). Decided March 31, 1942, Case No. 9910.

The Deep Hole Drilling Corporation assigned to appellants a fractional share of the oil and gas produced in the form of an overriding royalty.

> "In any case the intention of the parties is controlling and in the absence of a clear indication that

> such was the intent, the court will not construe royalty interests created for the duration of a specific oil and gas lease as granting the right to enter upon the land in question for the purpose of carrying on oil production or as creating a tenancy in common in the profit of a prendre for that purpose." (*La Laguna Ranch Co. v. Dodge, supra.*)

No intention to establish a joint operation or a cotenancy was proved by the trustee. Certainly none is disclosed by the assignments or other facts.

The facts establish that appellants acquired a fractional interest in the oil for a valuable consideration after the well had been drilled and on production for more than thirty days and was averaging over 400 barrels per day. [Tr. p. 43.] Appellants were assured by the Deep Hole Drilling Corporation that the obligations outstanding against Well #1 would be paid from the $11,400.00 received from the sale of the royalty interests to appellants, with the exception of the claim of Howard Supply Company [Tr. p. 31] who had waived its right to interfere in any way with the said royalty interest. [Tr. p. 46.] These facts were all ascertained and relied upon at the time appellants acquired their interest and under these circumstances they can hardly be placed in the category of speculators, but purchased a royalty interest, the value of which was definitely ascertained. The debtor's obligations totaled only $3,964.00 exclusive of Howard Supply Co. The company was then solvent. It had $6,650.00

cash in the bank and $8.000.00 due to it for oil from Well #1 from the Standard Oil Company. This was disclosed by the verified application to the Commissioner of Corporations, particularly Exhibit "G," which was thereto attached. [Tr. pp. 33-54. See p. 45.]

Appellants respectfully submit that no joint adventure or co-adventure relation in the drilling or operation of Well #1 or otherwise may logically be concluded from such facts, but on the contrary the law requires the conclusion that appellants acquired an ownership in the oil, which should be protected.

2. It appears from the facts of the case that unpaid creditors of Well #1 were known on February 5, 1939, the date the well was placed on production. There were funds available for payment of their claims, yet these creditors continued to extend credit to the Deep Hole Drilling Corporation for more than seven months thereafter and to extend other and additional credit for drilling another well, which resulted in the eventual bankruptcy of the corporation. It is neither equitable nor just to permit these creditors or the trustee in bankruptcy to reach back over the months and say that the bankruptcy court must protect such creditors and in doing so ignore the vested property rights of appellants, who acquired their interest in the oil, for value, long prior to bankruptcy.

The twelve per cent overriding royalty interest in the oil and gas produced from Well #1 conveyed to appellants was an interest in land and was not a mere personal right

enforceable only against the Deep Hole Drilling Corporation.

> *Emerson v. Little Six Oil Co.*, 3 F. (2d) 265. (Certiorari denied 268 U. S. 700, 69 L. Ed. 1165);
>
> *Wortley v. Wood-Callahan Oil Co.*, 17 A. C. 803; 112 Pac. (2d) 226.

As was said by the Supreme Court of Texas in *Sheffield v. Hogg,* 124 Tex. 290; 77 S. W. (2d) 1024,

> "Were the stability furnished by these rules (holding royalty interests to be real property) withdrawn and the fundamental contracts on which the oil business so largely rests be adjudged by the Supreme Court to create mere rights in personality at some uncertain date in the future, the structure of the business would be seriously, if not fatally, jeopardized."

The creditors of Deep Hole Drilling Corporation cannot stand in a more favored position than the corporation itself where the conveyance to appellants took place long prior to bankruptcy and for value. It is respectfully submitted that the court erred in subordinating appellants' interest in the oil and proceeds thereof in the hands of the Standard Oil Company to the claims of such creditors. A mere personal claim against a bankrupt might be postponed to general creditors' claims, but the appellants' title to the oil and the proceeds thereof may not be so treated. Such interest in the oil is not a part of the bankrupt's estate. It was not subject to levy or sale under judicial process and it was not transferrable by the bankrupt.

POINT III.

The Court Erred in Making Said Order and Said Order Is Against the Law.

A. Appellants' twelve per cent overriding royalty interest in oil produced from the land on which Well #1 was located was not part of the bankrupt's estate.

B. The oil was purchased at the well by Standard Oil Company. [Tr. p. 27.] Title passed to the said purchaser upon delivery [Tr. p. 27], subject to the irrevocable division order and the conveyances of the oil to appellants. The proceeds from the oil were therefore held by the Standard Oil Company for appellants' benefit. (See authorities under Point I, C(2).

In the case of *Taylor v. Odell,* 50 A. C. A. 158, at page 167, the court had this to say with respect to an overriding royalty:

> "Such royalty was an incorporeal interest in real property 'subject to the same requirements and protected by the same safeguard' (La Laguna Ranch Co. v. Dodge, *supra*) * * * The assignment of the royalty interest in the well of the Two and One Oil Company vested in plaintiffs an interest in the oil produced by that company. When the money for production was received by Two and One, it was held in trust for plaintiffs if the company had knowledge of defendants' assignment" and
>
> "As long as he held their moneys he was trustee for plaintiffs for the moneys in his custody."

C. The Court failed to follow the law of the State of California with respect to the property interest acquired in said oil by appellants.

1. The Court followed the case of *In re Lathrap,* 61 F. (2d) 37, in effect held that the interest conveyed was personal property and therefore appellants had no title to the oil itself. The cases heretofore cited establish that the interest conveyed was an interest in real property and is subject to the safeguards of such conveyances.

2. The Court further concluded that appellants were joint adventurers or co-adventurers in producing Well #1, whereas the Supreme Court of California has determined that where no control was exercised over the lessee by those interested in the proceeds of oil and that material and labor were not furnished upon their personal credit, no joint adventure or partnership existed. (*Spier v. Lang, supra.*)

3. Rules of property and of law established by the California courts must be followed by the Federal Courts.

Laugharn v. Bank of America, 88 F. (2d) 551.

POINT IV.

The Court Erred in Making Said Order, in That, It Relied Upon the Case of In re Lathrap, 61 F. (2d) 37, as Authority for Subordinating Appellants' Interest in the Oil and the Proceeds Thereof to the Claims of Creditors.

A. The *Lathrap* case has been overruled by the case of *Laugharn v. Bank of America,* 88 F. (2d) 551.

The *Lathrap* decision held that the royalty per cent holders did not acquire any interest in the oil itself, that the assignments gave them merely the right to participate in proceeds from the sale of the oil; that the assignment was measured in money, not in oil; that certificate holders therefore became participants in a common enterprise similar to stockholders or investors who must stand aside upon liquidation until creditors have been paid.

After the *Lathrap* decision the Supreme Court of California, in the case of *Callahan v. Martin,* 3 Cal. (2d) 110; 43 Cal. (2d) 788, 101 A. L. R. 871, held that the lessee under an oil and gas lease had an interest in real property capable of assignment or conveyance. Other cases followed to the effect that assignments of lessee's royalty interests were conveyances of an interest in real property.

Thereafter in the case of *Laugharn v. Bank of America,* 88 F. (2d) 551 (9th Cir.) the Circuit Court of Appeals was called upon to determine the nature of an assignment of a lessee's interest in oil being produced, given as security for a loan. The Court said, at page 553 of the decision, as follows:

> "As the law then stood, this court was presented with two cases involving the nature of royalty inter-

est holder's right whose interest was acquired from a lessee in an oil and gas lease. It was held that neither the owner nor the lessee had any present title to oil in place, and therefore the assignment by the lessee did not convey the present title. *In re* Lathrap (C. C. A. 9), 61 F. (2d) 37; Bank of America Nat. Trust & Savings Ass'n v. Fisher (C. C. A. 9), 61 F. (2d) 53."

"Thereafter, the Supreme Court of California, in Callahan v. Martin, 3 Cal. (2d) 110, 43 P. (2d) 788, 792, 101 A. L. R. 871, considered the same issue and held that after an oil and gas lease, both the lessor and the lessee had an interest in real property capable of assignment or conveyance."

"If previous decisions of this court, in the absence of state court decisions, established a rule of property, which was later changed by state statute, can it be argued that this court must follow its previous decisions? If the law of the state is established either by statute or judicial decisions, this court must follow the law of property as determined by the highest state court. Therefore, we must and do overrule the prior decisions of this court in so far as they are inconsistent with the settled law of California as adjudged by the California courts. On this basis we hold the assignments in the instant case to be conveyances of an interest in real property, and not to be executory contracts."

Since the above decision, the California Supreme Court in the case of *La Laguna Ranch Co. v. Dodge, supra,* on June 20, 1941, established definitely that the assignment of an overriding royalty interest in oil and the proceeds thereof carved out of a leasehold estate by the lessee, conveys an incorporeal interest in real property.

The court stated that the holders of such royalty interests contemplated nothing more than the receipt of their share of the oil and gas production and that the lessee conveyed merely a fractional share of the oil and gas produced in the form of an overriding royalty.

In the case of *Schiffman v. Richfield Oil Co.*, 8 Cal. (2d) 211, at page 227, the California Supreme Court stated,

> "The subject matter of royalty assignments is specific—an undivided interest in the oil to be produced under a specific lease or from a specific well during the term of the lease, or an interest in the proceeds of such oil. A transferee of the leasehold with notice on broad equitable principles must recognize the royalty holders interest in oil produced by such transferee."

and on page 228,

> "The royalty assignees interest in the proceeds must be upheld whether the assignment is of oil to be produced, saved and sold or of proceeds of such oil."

It is respectfully urged that by reason of the above cited cases the reasoning of the *Lathrap* case relegating overriding royalty interest holders to the category of joint adventurers or investors in a common enterprise on the ground that the assignments merely permitted the holder to participate in profits of the enterprise, can no longer apply and that the said case has been overruled by the *Laugharn* case.

B. Even though it should be held that the *Lathrap* case has not been overruled, the facts upon which that decision was based are materially at variance with the facts of this matter, in that,

1. In our case the well had been completed and was on production for many weeks before appellants acquired their royalty interests. In the *Lathrap* case the royalty interests were sold to provide funds for the drilling of the well.

2. In our case the assignment or conveyance was of an "overriding royalty interest of 12% of the oil produced, saved and sold" and without deduction of operating costs. In other words, the interest was measured in oil. In the *Lathrap* case the interest sold was 1% of the gross proceeds received from the sale of 100% of the oil. The interest was measured in money, not in oil.

3. In our case the assignments were recorded. Creditors had notice of the conveyance, but, disregarding this, continued to extend credit to the debtor as to the unpaid balance of drilling costs of Well #1 for seven months after it was placed on production, and furnished additional material and labor in other enterprises for the debtor, which resulted in the eventual bankruptcy of the debtor.

4. In our case, irrevocable division orders were obtained directing the Standard Oil Company to pay the proceeds from appellants' said 12% of the oil to appellants, which was accepted and done until the debtor's petition was filed herein. In the *Lathrap* case the court stated there had been no oil sold to the holders of the assignments and no trust or special fund had been created for their benefit.

5. In our case the stipulated facts do not permit a finding of joint, co-adventure or partnership relation between appellants and the bankrupt.

It is respectfully submitted that the court erred in following the *Lathrap* case and that that decision is not applicable to the facts of our case, for the reasons above stated. The company was solvent when appellants purchased their share of the oil to be produced. The creditors could have refused to extend credit to the debtor after this conveyance, but chose to take their chance of payment from continued business of the debtor and production from other wells. Appellants purchased an interest in the oil then being produced from the land on which Well #1 was located for $11,400.00. Their interest was definitely ascertained and measured. The only speculation, if any, to be charged to them was that of the length of time oil would be produced from the well and the quantity thereof.

Appellants submit that there is no justification in permitting creditors to receive the appellants' share of the oil and the proceeds thereof which was purchased in good faith, not as a speculation and long prior to bankruptcy and at a time the company was solvent, when those creditors continued to extend credit to the debtor for so many months with full knowledge of appellants' ownership of 12% of the oil.

Conclusion.

Appellants urge that the order from which this appeal is taken should be reversed and that the restraining order should be dissolved.

Respectfully submitted,

FLEMING & ROBBINS and
C. S. TINSMAN,
Attorneys for Appellants.